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ORIGINAL

Mr. John Nuechterlein
Deputy General Counsel
Office of the General Counsel
Federal Communications Commission
445 12th Street, SW
Washington, D.C. 20554

Re: Ex Parte Presentation
CC Docket No. 99-68
Inter-Carrier Compensation for ISP-Bound Traffic

Dear Mr. Nuechterlein:

Attached please find a legal analysis of issues raised in the reciprocal compensation docket. Specifically, SBC shows that: (1) internet traffic is not subject to § 251(b)(5), (2) even if the Commission concludes that internet traffic is subject to § 251(b)(5), it can establish a bill and keep regime for such traffic, (3) the Commission may order bill and keep for local traffic as well as internet traffic or, at a minimum, condition the availability of bill and keep for internet traffic on the availability of bill and keep for local traffic and (4) although no transition to bill and keep is necessary, the Commission has the authority to establish a reasonable transition to bill and keep, including caps on traffic ratios.

Respectfully Submitted,

Gary L. Phillips

Attachment
cc: C. Wright
K. Dixon
A. Gomez
D. Shetler
R. Beynon
J. Goldstein
D. Attwood
J. Jackson
T. Preiss
R. McDonald
A. Candeub

I. INTERNET TRAFFIC IS NOT SUBJECT TO § 251(b)(5)

THERE ARE AT LEAST FOUR REASONS WHY INTERNET TRAFFIC IS NOT SUBJECT TO § 251(b)(5):

REASON #1: § 251(b)(5) APPLIES TO THE TRANSPORT AND TERMINATION OF TELECOMMUNICATIONS AND A CLEC THAT DELIVERS INTERNET TRAFFIC TO AN ISP IS NOT TERMINATING TELECOMMUNICATIONS.

REASON #2: THE RECIPROCAL COMPENSATION SCHEME IS BASED ON PRICING ASSUMPTIONS THAT DO NOT APPLY TO INTERNET TRAFFIC.

REASON #3: THE APPLICATION OF § 251(b)(5) TO INTERNET TRAFFIC CANNOT BE SQUARED WITH § 251(i) OF THE ACT.

REASON # 4: ALTHOUGH ISPs ARE NOT REQUIRED TO PAY CARRIER ACCESS CHARGES TO ILECS, THE EXEMPTION ITSELF IS A PART OF THE FCC's POLICIES AND RULES FOR ACCESS SERVICES AND THEREBY IS SUBJECT TO § 251(g) OF THE ACT.

REASON #1: INTERNET TRAFFIC DOES NOT TERMINATE AT THE ISP SERVER

A. THE END-TO-END ANALYSIS IS CONTROLLING

1. THE END-TO-END ANALYSIS IS NOT JUST A JURISDICTIONAL TOOL, BUT AN ANALYTICAL CONSTRUCT USED TO DEFINE THE BOUNDARIES OF A COMMUNICATION BOTH FOR JURISDICTIONAL AND REGULATORY PURPOSES.

- The Commission has applied the end-to-end analysis every time it has been called upon to determine the end points of a communication, including in matters having nothing to do with jurisdiction.

    - *Teleconnect v. Bell Telephone Co:* the Commission applied end-to-end analysis in rejecting arguments that an 800 call used to connect to an IXC switch was a separate communication for purposes of the access charge regime from the long-distance call placed from that switch.

      Both the Bureau and the Commission expressly recognized that there is no basis for limiting end-to-end principles to jurisdictional determinations:

      CCB: "Just as Commission regulation does not end with an intermediate switch, neither does the character of [a] call change at [an] intermediate switch."

FCC: "While Nevada Bell and Pacific Bell attempt to distinguish the so-called 'jurisdictional' nature of a call from its status for 'billing' purposes, they present no persuasive argument nor any authority to support their contention that this distinction has legal significance."

- *International Telecharge, Inc. v. SWBT et al:* FCC held that an 800 call used to access an operator service center was, for access charge purposes, part of a single-end-to-end communication (11 FCC Rcd 10061).

- *Bill Correctors, Inc. v. Pacific Bell,* FCC applied end-to-end analysis in determining status of FX traffic under the access charge regime (10 FCC Rcd 2305).

- *AT&T Corp. Bell Atlantic-PA:* FCC applied end-to-end analysis in holding that "a call redirected by call forwarding does not terminate at the location dialed by the caller" and thus does not warrant the application of "intermediate" CCL charges (14 FCC Rcd 556).

  - *Request by RCN Telecom Services and Bell Atlantic for Clarification:* FCC applied end-to-end analysis in holding that Bell Atlantic is not providing interLATA service when it hands off traffic to a CLEC across LATA boundaries if the ultimate beginning and end points of the communication are in the same LATA (14 FCC Rcd 13861).

2. THE END-TO-END ANALYSIS APPLIES AS MUCH TO ISP-BOUND TRAFFIC AS TO TRADITIONAL LONG-DISTANCE VOICE TRAFFIC.

- End-to-end analysis is used to gauge the boundaries of <u>all</u> types of communications by wire and radio, not just traditional long-distance voice traffic:

  - *Idaho Microwave, Inc. v. FCC* (applying end-to-end analysis to television signals carried on microwave facilities) (352 F.2d 729)

  - *General Telephone Co. v. Calif.* (applying end-to-end analysis to cable television programming distributed over telephone company lines) (413 F.2d 390)

- End-to-end analysis applies as much to packet-switched communications as any other communications. As the Commission recognized, packet switched services are "pure transmission services" that "do[] no more than transport information of the user's choosing between or among user-specified points, without change in the form or content of the information as sent and received[.]" CC Docket 98-147, FCC 98-188, 8/7/98, ¶ 35.

- CLECs effectively concede that the end-to-end analysis applies to Internet communications because they concede that ISP-bound traffic is jurisdictionally interstate under that analysis. *See, e.g.,* AT&T Comments at 3 (there is no doubt that Internet traffic is interstate in character); Pac-West Comments at 4 (the Commission's determination that Internet traffic is interstate as not disturbed by the Court); Time Warner Comments at 8 (end-to-end analysis is

appropriate for jurisdictional classification of Internet traffic); Joint Comments of Focal Communications Corp., Allegiance Telecom, Inc., and Adelphia Business Solutions, Inc. at 3-4 (on an end-to-end basis, it is understandable that many Internet communications would appear to be interstate under Section 151 of the Communications Act);

3. CLECS HAVE NOT IDENTIFIED A SINGLE INSTANCE IN WHICH ANY OTHER CONSTRUCT HAS BEEN USED TO IDENTIFY THE BOUNDARIES OF A COMMUNICATION.

B. THE FACT THAT ISPs ARE CLASSIFIED AS INFORMATION SERVICE PROVIDERS DOES NOT MEAN THAT ISP-BOUND TRAFFIC TERMINATES AT THE ISP SERVER.

- Since 1983, the FCC has recognized that LECs provide access service when they deliver traffic to an ESP. Access service is defined in FCC rules as "services and facilities provided for the origination and termination of any interstate or foreign telecommunication." (47 CFR § 69.2) Thus, for 17 years, the FCC has recognized that telecommunications do not terminate upon delivery of traffic to an ESP.

- The fact that under FCC regulations, ISPs are generally treated as users, not providers, of telecom services does not mean, as the court suggested, that ISPs are no different from other communications-intensive businesses, such as pizza delivery firms, travel agents, etc. Unlike these other businesses, ISPs do not merely use telecommunications to conduct their businesses; they forward subscriber-initiated communications to destinations on the Internet.

- In this respect, the Court's suggestion that ISPs originate communications on behalf of their subscribers was wrong.

    - *See e.g., Advanced Services Remand Order* at ¶ 35: "the service provided by the local exchange carrier to the ISP is ordinarily exchange access service because it enables the ISP to transport the communication initiated by the end-user subscriber located in one exchange to its ultimate destination in another exchange."

- The fact that telecom services and information services are deemed mutually exclusive regulatory categories is a red herring.

    - It means only that a provider of an information service is not considered a provider of a telecommunications service by virtue of the telecommunications underlying its information service. (*Universal Service Report,* ¶ 57) It does not mean that the telecommunications services underlying the information service does not exist at all.

    - In fact, the FCC expects the provider of the telecom service underlying an information service to contribute to universal service support mechanisms. It even left open the possibility that the ISP itself might be required to contribute to universal service support to the extent it provides its own backbone services.

- In *BellSouth MemoryCall Order*, FCC squarely held that, for purposes of determining the boundaries of a communication, a telecom service that connects to an information service is no different from an ordinary phone call:

> "When a caller is connected to BellSouth's voice mail service ... there is a continuous path of communications across state lines between the caller and the voice mail service, just as there is when a traditional out-of-state long distance voice telephone call is forwarded by the local switch to another location in the state and answered by a person, a message service bureau or customer premises answering device." (7 FCC Rcd 1619, ¶ 9 (emphasis added))

  - The fact that the ISP may engage a third party to provide the telecommunications services underlying its information services does not mean that the telecommunications sent to the ISP terminates at the ISP server. To the contrary, irrespective of whether the ISP itself provides the continuing telecommunications link or uses a third party, that link undeniably exists and compels the conclusion that the telecommunications sent to the ISP does not terminate at the ISP server.

C. ISP-BOUND TRAFFIC DOES NOT TERMINATE AT THE ISP SERVER UNDER SECTION 51.701(d) OF THE COMMISSION'S RULES.

- While § 51.701(d) describes the termination "function" in order to distinguish that "function" from the "transport" function (*see Local Competition Order* at ¶ 1040), "termination" is not defined solely with respect to functionality, as CLECs claim. Rather, under the express terms of the rule, the termination functionality must be provided in connection with "local telecommunications traffic" that is delivered to the "called party."

- In the *Local Competition Order*, the Commission rejected a purely functional definition of "termination," noting that under such a definition, access traffic, as well as local traffic, would be subject to reciprocal compensation. (¶ 1033)

- ISP-bound traffic is not "local telecommunications traffic."

  - The CLEC claim that the definition of "termination" should be bootstrapped into the definition of "local telecommunications traffic" – such that "local telecommunications traffic" is simply traffic for which the "terminating" and "originating" functionalities are performed within the same local calling area – goes too far: if that were true, an access code call delivered to an IXC within the end user's local calling area would likewise be subject to reciprocal compensation, in express violation of the Commission's stated policy.

- The ISP is not the "called party."

- While consumers use an ISP as a conduit through which to send and receive transmissions over the Internet, their intent is not to communicate with the ISP, but to send and receive information to and from the Internet. *E.g.*, a user that sends an e-mail or that participates in on-line chat is communicating with the person to whom the e-mail is addressed or with those in the "chat room," not her ISP. Likewise, a user that sends or retrieves information to or from a web site is communicating with the proprietor of that site, not her ISP.

- ISP-bound traffic could not be interstate if the ISP were the called party. Rather, there would be two separate calls, the first of which would be jurisdictionally intrastate.

- In *Teleconnect v. Bell Telephone Co.*, the FCC specifically referred to the person at the ultimate end point of the communication – not the intermediate switching point – as the "called party."

- Even AT&T agrees that § 51.701(d) "in no way purports to define what traffic is 'local' and what traffic is 'non-local."

- The D.C. Circuit did not hold otherwise. In discussing this issue, the Court was merely describing WorldCom's arguments, not offering its own conclusions.

D. THE COMMISSION HAS NEVER RETREATED FROM THE VIEW THAT INTERNET TRAFFIC IS ACCESS TRAFFIC, NOT LOCAL TRAFFIC.

- In stating in the *Access Reform Order* "it is not clear that ISPs use the public switched network in a manner analogous to IXCs," the Commission in no way implied that ISPs do not, in fact, use access services. Rather, at most the FCC was suggesting that ISPs *may* use the network in ways that warrant a different kind of access *pricing* structure than is used for long-distance services.

- In fact, that is exactly what the FCC said: "The access charge system was designed for basic voice telephony provided over a circuit-switched network, and even when stripped of its current inefficiencies it may not be the most appropriate pricing structure for Internet access and other information services. (12 FCC Rcd at 16134)

- The FCC reaffirmed this in the *Advanced Services Remand Order,* when it held that xDSL service is exchange access.

- To the extent the D.C. Circuit was confused on this point, it was because the FCC did not fully explain the access charge exemption in the *Declaratory Ruling* or in its briefs.

E. THE STATUS OF ISP-BOUND TRAFFIC AS EXCHANGE ACCESS OR TELEPHONE EXCHANGE SERVICE HAS NO BEARING ON WHETHER IT IS SUBJECT TO RECIPROCAL COMPENSATION.

- Neither §251(b)(5), nor the Commission's reciprocal compensation rules apply by their terms to "telephone exchange service." Rather, they apply to "local telecommunications traffic" – a term that is defined differently from the term "telephone exchange service." Thus, it does not matter, for reciprocal compensation purposes, whether ISP-bound traffic fits the statutory definition of telephone exchange service (which it does not).

- In any event, the Commission has now ruled that ISP-bound traffic is exchange access, and that ruling is entitled to *Chevron* deference.

REASON #2: THE RECIPROCAL COMPENSATION REGIME IS BASED ON PRICING ASSUMPTIONS THAT DO NOT APPLY TO INTERNET TRAFFIC

A. THE FCC HAS LONG RECOGNIZED THAT ISPs PAY FOR THE ACCESS SERVICES THEY USE.

- Reciprocal compensation is required today for local traffic because the local service fees collected by LECs are deemed (rightly or wrongly) to compensate them for outbound, not inbound, traffic. Thus, when 2 LECs collaborate to complete a local call, the originating LEC – which has received compensation for the call – must pay reciprocal compensation to the terminating LEC – which has not.

    - The premise of reciprocal compensation is that, although the terminating LEC receives local revenues from its customer, those revenues do not compensate the LEC for inbound traffic, only for outbound traffic.

- But when two LECs collaborate to deliver Internet traffic to an ISP, the LEC serving the ISP is indisputably compensated by the ISP for the call. Although ISPs are exempt from paying carrier access charges, the FCC has never institutionalized free access for ISPs. Rather, ISPs are permitted to pay a different amount for their access services – specifically: (1) the business line rate or other state tariffed charge; (2) the special access surcharge; and (3) the SLC.

- That these payments were surrogate access charges has been clear from the beginning.

    - In one of the original access charge orders, the FCC expressly noted that the local business line rate paid by ESPs covers the cost, not only of the ESP's telephone line, but also the switching function used to deliver interstate traffic to the ESP – the very function covered by reciprocal compensation. (97 FCC2d 682 ¶ 88)

- In the same order, the FCC held that ESPs may be assessed special access surcharges, which it characterized as a "surrogate" for interstate access charges.

- In its 1987 NPRM proposing to lift the ESP exemption, the FCC reiterated its understanding that ESPs pay for the access services they use, expressing concern that "the charges currently paid by enhanced service providers do not contribute sufficiently to the costs of the exchange access facilities they use[.]" (2 FCC Rcd. 4305, ¶ 7)(emphasis added)

- When, in the *Access Reform Proceeding* in 1997, ILECs argued that they were unable to recover their costs associated with ISP-bound traffic as a result of the access charge exemption, the FCC noted, *inter alia,* that "ISPs do pay for their connections to incumbent LEC networks by purchasing services under state tariffs." (12 FCC Rcd. at 16134)

- Moreover, the Commission went on to suggest to ILECs that, if they could not recover their costs of ISP-bound traffic, they should raise the rates they charge ISPs. *(Id.)*

    - This invitation to ILECs to raise ISP rates demonstrates the FCC's understanding that ISPs do, in fact, contribute to the cost of the access services they use.

    - It also undercuts any conceivable basis for reciprocal compensation: (1) if an ILEC must look to its ISP customers for cost recovery on Internet calls, why should not the same be true when a CLEC wins the business of that ISP? (2) if ILECs must look to their ISP customers for cost recovery, how can they be asked to pay reciprocal compensation when they lose that revenue to a CLEC?

- The D.C. Circuit also has recognized that ISPs – not the originating end users - pay for the access service they receive. In its order upholding the exemption, it stated that "the access charges paid by ... ESPs may thus not fully reflect their relative use of exchange access." (*NARUC v. FCC,* 737 F.2d at 1136)

B. THAT CLECS ARE COMPENSATED BY THEIR ISP CUSTOMERS FOR THE DELIVERY OF INTERNET TRAFFIC IS NOT JUST A MATTER OF REGULATORY THEORY, BUT PLAIN COMMON SENSE AND REAL-WORLD ECONOMICS.

- CLECs who serve ISPs perform one function only for those ISPs: they deliver inbound Internet traffic to those ISPs. Thus, it is impossible to view the revenues they receive from their ISP customers as anything other than compensation for this function.

- The access charge exemption does not apply to CLECs. Because CLEC rates are deregulated, the CLECs decide – just as they do for ordinary voice traffic - what rate to charge their ISP customers for the access services they provide to those customers. They have every ability to set a rate that covers their costs.

- CLECs are not constrained in their pricing by ILEC business line rates: ISPs typically do not use business lines for ISP-bound traffic. They use more sophisticated services, such as ISDN prime services.

- CLECs enjoy a number of cost savings over ILECs – which enable them to cover their costs with less revenue.

    - For example, ISPs may typically collocate their servers at CLEC switches– thereby eliminating virtually all loop costs.

    - CLECs also use scaled-down switches or SS7 gateways instead of switches – thereby reducing switching costs.

REASON # 3: THE APPLICATION OF RECIPROCAL COMPENSATION TO INTERNET TRAFFIC IS INCONSISTENT WTH SECTION 251(i)

- Section 251(i) provides that "nothing in [section 251] shall be construed to limit or otherwise affect the Commission's authority under section 201."

- The Commission has plenary authority under section 201 over interstate traffic (except to the extent § 221(b) limits FCC authority over corridor traffic)

- Internet traffic is jurisdictionally interstate.

    - Not one CLEC argues to the contrary in the record.

    - The D.C. Circuit conceded that Internet traffic is jurisdictionally interstate. Its principal concern with the *Declaratory Ruling* was why the end-to-end analysis should be used outside the jurisdictional context.

- The application of section 251(b)(5) to ISP-bound traffic necessarily would limit or affect the Commission's authority under section 201. It would strip the Commission of its plenary authority under that section. For example, the Commission would be without authority to establish an access charge regime – cost-based or otherwise – for Internet traffic.

- Therefore, subjecting Internet traffic to § 251(b)(5) would be inconsistent with § 251(i).

- Although the end-to-end analysis is not just a jurisdictional principle, a jurisdictional analysis is, therefore, highly relevant to the status of traffic under section 251(b)(5).

- Section 251(i) was not cited in the *Declaratory Ruling* or in the FCC's Brief to the D.C. Circuit.

REASON # 4: § 251(g) PRESERVES THE FCC's ACCESS CHARGE REGIME, INCLUDING ITS REGIME FOR ISPs.

- The FCC has acknowledged that Section 251(g) preserves its access charge regime for interexchange carriers, but section 251(g) is not limited to carrier access.

    - Section 251(g) applies by its terms to the Commission's "restrictions and obligations" for access services, including those relating to the "receipt of compensation." ISPs may be exempt from having to pay carrier access charges, but the FCC nevertheless has indisputably established "restrictions and obligations" with respect to ISP access. Specifically, the FCC has established an alternative access charge regime for ISPs – one in which ISPs pay: (a) business line or other state tariffed rates; (b) special access surcharge; and (3) the SLC.

    - Section 251(g) applies by its very terms to "information access."

II. EVEN IF THE COMMISSION CONCLUDES THAT INTERNET TRAFFIC IS SUBJECT TO § 251(b)(5), IT CAN ESTABLISH A BILL AND KEEP REGIME FOR SUCH TRAFFIC.

A. § 252(d)(2)(B)(i) OF THE ACT EXPRESSLY SANCTIONS A BILL AND KEEP REGIME FOR TRAFFIC SUBJECT TO § 251(B)(5) IF THE FCC FINDS THAT CARRIERS CAN RECOVER THE ADDITIONAL COSTS OF TRANSPORT AND TERMINATION UNDER SUCH A REGIME.

- § 252(d)(2)(B)(i) states that § 252(d)(2) shall not preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements).

    - In the *Local Competition Order,* the FCC misread the phrase "offsetting of reciprocal obligations" to mean "offsetting of reciprocal compensation payments." Hence, the FCC concluded that bill and keep is permitted only if traffic (and hence payments) are offsetting. A correct reading of the provision, however, is that the reference to "offsetting of reciprocal obligations" is simply a description of how a bill and keep arrangement works – *i.e.,* it is a regime in which neither carrier is obligated to pay reciprocal compensation. Thus §252(d)(2)(B)(i) authorizes the establishment of a bill and keep regime as an alternative means for carriers to recover their additional costs of transport and termination.

B. § 51.713 OF THE FCC'S RULES IS NO BAR TO THE IMPLEMENTATION OF A BILL AND KEEP REGIME FOR INTERNET TRAFFIC SINCE THAT RULE APPLIES TO LOCAL, NOT INTERNET TRAFFIC.

- § 51.713 is part of Subpart H in Part 51 of the Commission's Rules. Subpart H is entitled "Reciprocal Compensation for Transport and Termination of Local Telecommunications Traffic."

- § 51.701 states "[t]he provisions of this subpart apply to reciprocal compensation for transport and termination of local telecommunications traffic between LECs and other telecommunications carriers."

- § 51.713(b) states "[a] state commission may impose bill-and-keep arrangements if the state commission determines that the amount of local telecommunications traffic from one network to the other is roughly balanced with the amount of local telecommunications traffic flowing in the opposite direction."

- The FCC has already permitted states to implement a bill and keep regime for Internet traffic, notwithstanding that Internet traffic flows are anything but balanced.

- The FCC stated in its *Reciprocal Compensation Declaratory Ruling* "the Commission currently has no rule addressing the specific issue of inter-carrier compensation for ISP-bound traffic." ¶ 26.

- The assumptions underlying § 51.713(b) do not apply to Internet traffic. *See Local Competition Order* at ¶ 1112:

    - Contrary to the FCC's assumption about the cost of terminating local traffic (which is itself based on an incorrect reading of the "additional cost" standard), clearly the additional costs of delivering Internet traffic are *de minimis.*

        - There is ample record evidence to show that CLECs can serve ISPs far more efficiently and at far lower unit cost than other customers. For example, they can serve ISPs with switches that lack call origination capabilities or without a switch at all – through the use of SS7. Thus, the FCC's conclusion about the cost of terminating local traffic do not apply to Internet traffic.

    - Contrary to the FCC's assumption that, without reciprocal compensation, LECs cannot recover the cost of terminating local traffic, a LEC that serves an ISP does have the ability to recover its additional costs of transport and "termination" from that ISP. In fact, since a LEC that serves an ISP performs one function only for that ISP – the traffic "termination" function - it is impossible to view the revenues that LEC receives from the ISP as anything but compensation for this function.

    - Contrary to the FCC's assumption that bill and keep is not economically efficient and would distort carriers' incentives, it is reciprocal compensation for Internet traffic that is not economically efficient and that distorts carriers' incentives.

C. EVEN IF THE FCC INCORRECTLY VIEWED § 51.713 AS APPLYING TO INTERNET TRAFFIC, THE FCC HAS GIVEN AMPLE NOTICE TO JUSTIFY A MODIFICATION OF THAT RULE.

- The FCC's Public Notice specifically sought comment on all *ex parte* presentations submitted after the NPRM. Included among those *ex partes* were presentations proposing bill and keep for Internet traffic.

D. EVEN IF THE FCC CONCLUDES THAT INTERNET TRAFFIC IS SUBJECT TO § 251 (B)(5), THE FCC HAS AMPLE AUTHORITY TO MANDATE BILL AND KEEP FOR INTERNET TRAFFIC.

- The United States Supreme Court has affirmed that the FCC has broad authority to implement the provisions of section 251 and 252:

> "Section 201(b), a 1938 amendment to the Communications Act of 1934, provides that 'the Commission may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this Act. .... Since Congress expressly directed that the 1996 Act, along with its local-competition provisions, be inserted into the Communications Act of 1934, ... the Commission's ratemaking authority would seem to extend to implementation of the local-competition provisions. ... We think that the grant

in § 201(b) means what it says: The FCC has rulemaking authority to carry out the "provisions of this Act," which include § 251 and 252, added by the Telecommunications Act of 1996.

- Pursuant to this authority, the FCC may mandate bill and keep arrangements as the preferred vehicle for carriers to recover their costs of transport and termination.

- A bill and keep mandate would not tread on the rights of the states under section 252(c)(2) to establish in arbitration "any rates for interconnection, services, or network elements."

    - A bill and keep regime is not a price. It is a regulatory regime – or, in the words of the statute, an "arrangement" - that addresses who pays for transport and termination, as opposed to the rate that shall be paid for transport and termination. It is a decision that LECs shall recover the additional costs of transport and termination from end users, not the LEC that originated the call.

    - Even if bill and keep were viewed as a "zero compensation" mandate, nothing in the Act would preclude the FCC from mandating bill and keep. Section 252(c)(2) says that states, in arbitration, shall "establish any rates for interconnection, services, or network elements." (emphasis added). Thus the Act gives the states authority to establish rates, to the extent there has to be a rate. If the FCC establishes a pricing regime that obviates the need for a particular rate, that rule does not intrude on the rights of the states to establish the rates that must be set.

- To view a bill and keep arrangement as a rate is an excessively cramped view of bill and keep that is, not only wholly unwarranted, but incompatible with the proposals in the FCC's forthcoming NOI.

III. THE COMMISSION MAY ORDER BILL AND KEEP FOR LOCAL TRAFFIC AS WELL OR, AT A MINIMUM, CONDITION THE AVAILABILITY OF BILL AND KEEP FOR INTERNET TRAFFIC ON THE AVAILABILITY OF BILL AND KEEP FOR LOCAL TRAFFIC.

- The Commission may order bill and keep, not only for Internet traffic, but also for local traffic.
    - There are strong economic arguments for bill and keep. *See* Attachment A.
    - There is no "notice" problem: The Commission's Public Notice in this proceeding expressly sought comment on *ex partes* that had been filed since April 2000. Among those *ex partes,* is an SBC *ex parte*, filed on January 3, 2000, in which SBC "discussed the compelling public policy benefits of bill and keep for Internet traffic, as well as the possibility of linkages to a bill and keep system for local traffic." (emphasis added). *See* Public Notice, FCC 00-227, released 6/23/00 (seeking comment on prior *ex partes).* There also has been ongoing discussion in the record, not only of bill and keep for Internet traffic, but also for local traffic, and CLECs themselves argued in their comments that Internet traffic should be treated no differently from local traffic for reciprocal compensation purposes.
- If the Commission is nevertheless concerned about whether there has been adequate notice of a mandate with respect to local traffic, it may provide CLECs with a bill and keep option by conditioning the availability of bill and keep for Internet traffic on the availability (through, *e.g.,* an SGAT) of bill and keep for local traffic.
- There is sufficient basis in the record for such a condition:
    - The establishment of a bill and keep regime only for Internet traffic raises potentially thorny traffic identification issues that could compromise the integrity of the regime and tax the resources of carriers:
        - Because Internet connections are made with 7-digit numbers and over local interconnection trunks, Internet traffic looks like local traffic to the originating LEC.
        - A bill and keep regime for Internet traffic only raises concerns with respect to "mixed" traffic. For example, if a business establishes a local area network (LAN) for its employees and those employees can log on to that network to, *inter alia,* access the Internet, how will that traffic be identified and treated?
    - The FCC could conclude that gaming opportunities associated with all one-way traffic should be reduced to the maximum extent possible.
    - CLECs have argued that the elimination of reciprocal compensation for Internet traffic will lead to higher reciprocal compensation rates for local traffic.

Conditioning the availability of bill and keep for Internet traffic on the availability of bill and keep for local traffic will address that concern.

IV. ALTHOUGH NO TRANSITION TO BILL AND KEEP IS NECESSARY, THE COMMISSION HAS THE AUTHORITY TO ESTABLISH A REASONABLE TRANSITION TO BILL AND KEEP, INCLUDING CAPS ON TRAFFIC RATIOS.

- The Commission has ample authority to phase out a regulatory requirement over time, and it has done so on countless occasions. For example:
    - The Commission ordered a gradual phase-out of the transport interconnection charge (TIC) when it ordered LECs to migrate those charges over time into the tandem switching rate element. (*Access Reform Order* at paras. 166-169)
    - Having determined, in the *CALLS proceeding,* that switched access rates for most ILECs should be reduced to $.0055 per minute, the Commission ordered that those reductions be implemented over time through the operation of the x factor.
- Another independent basis upon which the Commission could establish caps is to reduce inappropriate and unintended regulatory arbitrage.
    - Currently incumbent LECs send18 times as much traffic to CLECs as they receive from CLECs, and 90% of the traffic that CLECs "terminate" is Internet traffic. The only explanation for such huge traffic imbalances is that reciprocal compensation payments, not market forces, are driving CLEC business decisions. In fact, in Iowa – which implemented bill and keep from the start – the traffic ratio is 1.3 to 1 and less than 1/2 of all minutes originated by Qwest and "terminated" by CLECs are for Internet traffic.
    - These skewed traffic ratios manifest a significant regulatory dysfunction that is contrary to the purposes of the 1996 Act. Congress sought to establish a deregulatory national framework driven by market forces, not a regime in which Government regulation co-opts the market and dictates investment. Moreover, it expected that the reciprocal compensation provisions of the Act would lead to broad-based local competition, not targeted efforts by carriers to game the system.
    - The FCC clearly has authority to address this problem through caps, even if the FCC finds that Internet traffic is subject to § 251(b)(5). Caps on traffic ratios would permit the FCC to phase-out unintended abuse and excessive gaming of the reciprocal compensation provisions of the Act. Indeed, the Commission has already recognized that states may deny reciprocal compensation to an entity that predominantly or exclusively serves ISPs to the exclusion of other customers. *Reciprocal Compensation Declaratory Ruling* at ¶ 24. If the states have the authority to deny reciprocal compensation to entities engaged in regulatory gamesmanship, surely the Commission – which has been charged with the responsibility for establishing rules implementing the reciprocal compensation provisions of the Act – has the same authority.

- Caps do not raise any issues about the states' authority under section 252(c)(2) to establish rates, since the states would continue to establish reciprocal compensation rates for traffic under the cap.

- Caps offer other benefits as well.

  - They obviate the need to distinguish between local and Internet traffic.

  - They eliminate any alleged incentive for ILECs to secure excessive reciprocal compensation rates (since during the transition ILECs would have to pure more in reciprocal compensation than they receive)

  - They encourage CLECs to sign up customers who originate traffic, since that increases the amount of Internet traffic for which they can bill reciprocal compensation.

A BILL AND KEEP SYSTEM FOR ISP-BOUND AND LOCAL TRAFFIC IS IN THE PUBLIC INTEREST AND SHOULD BE IMPLEMENTED WITHOUT DELAY

A. Reciprocal Compensation Displaces Market Forces as a Driver of CLEC Business Decisions.

1. It Encourages CLECs to Target Customers Who Terminate More Traffic Than They Originate.

In general, the cost of performing originating switching on a call exceeds the cost of terminating switching because the call set-up function is performed only at the originating end of the call. But in a reciprocal compensation regime, carriers are more generously compensated for call termination than for call origination. Specifically, while both carriers generally receive flat-rated local service revenues from their respective customers, the carrier that originates a call must pay reciprocal compensation to the carrier that terminates the call. The reciprocal compensation that must be paid by the carrier that originates the call offsets (and can even exceed) the flat-rated basic service revenues it receives from its customer. In contrast, the reciprocal compensation received by a carrier that terminates the call adds to the overall revenues that carrier receives from its customer – leaving it with net revenues consisting of its basic local service fees plus the reciprocal compensation it receives. As a result, it is more profitable for CLECs to target customers who terminate more traffic than they originate, and the greater the customer's imbalance, the more attractive is the customer to the CLEC. Conversely, the more traffic a customer originates relative to the amount of traffic it terminates, the less attractive is the customer.

The distorting effects of reciprocal compensation are most acute with respect to customers, such as ISPs, who receive large amounts of inbound traffic but make few or no calls. Not only do carriers receive potentially enormous reciprocal compensation payments to supplement their basic local service revenues when they serve these customers, they can serve these customers at a lower unit cost than other customers. For example, a CLEC that serves a customer, such as an ISP, that receives large volumes of one-way traffic will typically locate its switch in close proximity to that customer in order to minimize its transport costs. Because that customer does not originate any traffic, the CLEC need not worry about hauling traffic back to the originating LEC. Also, a CLEC can dedicate low-cost equipment to serve the needs of customers with large volumes of one-way traffic. For example, CLECs can use scaled-down switches or modem banks with SS7 capabilities to serve their ISP customers, thereby avoiding the costs of a typical local switch. In this respect, the arbitrage opportunity associated with high volume, one-way traffic, such as ISP-bound traffic, is accentuated.

The facts underscore the distorting effect of reciprocal compensation in telecommunications markets. As noted in our November 3 *ex parte,* CLECs "terminate" 18 times more traffic than

they originate, and 90% of the traffic for which CLECs bill reciprocal compensation is ISP-bound traffic. These numbers manifest a significant market dysfunction that can only be attributed to reciprocal compensation.

- *Under a bill and keep regime, carriers would have no greater incentive to serve customers that terminate traffic than customers that originate traffic. A LEC, like any other business entity, would recover its costs from its customers, and its business decisions would be based – not on regulatory arbitrage - but on the dictates of the marketplace, as Congress intended.*

2. Reciprocal Compensation Discourages Competition for Residential Consumers

While a reciprocal compensation regime gives CLECs strong incentives to pursue customers with large traffic imbalances, it reduces their incentive to serve residential consumers. The reasons are many. First, residential consumers do not, as a rule, receive more calls than they make, certainly not in large numbers. Thus, they do not generate large reciprocal compensation imbalances. Second, the provision of service to residential consumers diminishes the reciprocal compensation arbitrage opportunity that can be created by targeted customers with high volumes of incoming traffic and little or no outbound traffic. For example, a CLEC that serves an ISP would lose the reciprocal compensation revenues generated thereby if it also served the consumers who were the customers of that ISP. Third, the provision of service to residential consumers places CLECs at risk of having to pay large amounts of reciprocal compensation to other carriers. If one of those consumers, for example, accesses an ISP not served by the CLEC, the CLEC would be forced to pay reciprocal compensation to the LEC that is serving that ISP. Rather than forego the reciprocal compensation revenues and, worse yet, risk having to pay them, CLECs have incentives to avoid the residential market altogether.

- *Under a bill and keep regime, this disincentive to serve residential consumers would be eliminated. Carriers would not be able to net more reciprocal compensation by avoiding residential consumers, nor would they face the risk of having to pay significant amounts of reciprocal compensation if they served residential customers.*

3. Reciprocal Compensation Creates Artificial Disincentives to Invest in Advanced Services and More Efficient Technologies and is Thereby Inconsistent With Section 706 of the 1996 Act.

Using the circuit-switched network is an inefficient method of carrying data. Because reciprocal compensation is available only for traffic sent by an ILEC to a CLEC over the circuit-switched network, CLECs have a disincentive to provide Internet service in a more advanced and efficient manner. Not only does it create an artificial disincentive for CLECs to deploy xDSL services, it discourages deployment of <u>any</u> technology that would not generate reciprocal compensation.

Reciprocal compensation may also create disincentives for ISPs to deploy advanced services. While it is unclear the extent to which CLECs share their reciprocal compensation subsidy with their ISP customers, it is clear that CLECs have the ability to do so: because they recover the

full costs (and then some) of serving their ISP customers from reciprocal compensation, they can serve their ISP customers profitably even if they charge them little or nothing. To the extent that ISPs thereby receive below-cost dial-up service, ISPs are given an artificial incentive to rely on dial-up access in lieu of other, more efficient or more advanced forms of Internet access. In this respect, the availability of reciprocal compensation for ISP traffic is directly contrary to the 1996 Act's goal of encouraging the deployment of advanced capabilities.

- *Bill and keep eliminates this artificial disincentive to use dial-up instead of more efficient, more advanced Internet access capabilities. Indeed, because a bill and keep regime will promote market-based competition for the business of ISPs, bill and keep will give LECs incentives to provide the most efficient and advanced Internet access capabilities to their ISP customers. Bill and keep will thus promote the goals of section 706 of the Act.*

B. Reciprocal Compensation Co-Opts Real Competition in the Marketplace.

Because, for a number of reasons, including the distorting effects of reciprocal compensation, incumbent LECs serve the vast majority of residential customers, incumbent LECs receive little or no reciprocal compensation when they serve a customer, such as an ISP, with a large traffic imbalance. Consequently, when an incumbent LEC competes for the business of such customers, it must price its service in a way that permits it to recover all of its costs of serving that customer from the customer itself. This, of course, is as it should be. The problem is that the same rule does not apply to CLECs. When a CLEC competes for the business of an ISP or other customer with large volumes of incoming traffic, the CLEC can anticipate, not only the revenues it receives from that customer, but also large amounts of reciprocal compensation. The CLEC can draw on those anticipated reciprocal compensation revenues to undercut any competing bid by the incumbent LEC, which effectively co-opts true competition for that customer.

- *Under a bill and keep regime, all carriers will compete fairly and on the merits for the business of ISPs and other customers with large traffic imbalances. Success in the market will be dictated by the quality and price of their services, not the selective availability of a subsidy that can be used to defray costs. CLECs frequently claim that they have been successful in signing up ISPs because they can serve them more efficiently. If they can do so, they will continue to succeed in this marketplace, but for the right reasons – not because of regulatory arbitrage.*

C. Reciprocal Compensation Sends the Wrong Market Signals, Resulting in Inefficient Utilization of Telecommunications Networks.

1. Setting the Right Reciprocal Compensation Rate is Effectively Impossible.

Setting rates by regulation is always an inexact science. Setting an accurate reciprocal compensation rate is particularly problematic because the cost of terminating a call necessarily varies by carrier and by type of call. In addition, those costs will vary over time. Thus, unless reciprocal compensation rates are based on a continually updated showing by each carrier of its

actual costs of terminating different types of traffic, those rates will necessarily deviate from each carrier's actual costs.

This problem is exacerbated by regulatory interpretations of section 252(i) pursuant to which LECs may adopt the reciprocal compensation provisions of other interconnection agreements. That interpretation effectively allows any LEC to adopt the cost structure of another LEC, irrespective of whether that rate reflects its own costs.

The problem is further exacerbated by the failure of most regulators to distinguish properly among different types of traffic with different cost characteristics – most notably, ISP-bound traffic and local traffic.

Theoretically, it might be argued that, if the LEC that pays reciprocal compensation can recover its reciprocal compensation payments from its customers, then reciprocal compensation rates would be driven to efficient levels, as customers adjust their calling patterns to minimize reciprocal compensation charges. But that is not likely to happen because states are not apt to adopt minute-of-use rate structures for basic local calling. Moreover, the transaction costs of any pass-through system would be prohibitive in any event. LECs could not practicably charge different amounts for different calls based on the reciprocal compensation rate of the terminating LEC, nor would consumers have the information necessary to make informed decisions.

In short, the disciplining effects of the market cannot be harnessed. Reciprocal compensation will always be purely a matter of regulatory fiat. As such, it will always be inferior to a market-based approach, and it will require the very type of hands-on regulation that the 1996 Act was intended to displace.

- *Under a bill and keep regime, carriers that terminate calls will charge market-based rates for the termination functionality. There is no need for regulators to estimate termination costs.*

2. Per-minute reciprocal compensation rate structures are inherently inefficient.

Traffic termination costs are to a certain extent fixed. The Commission has long recognized that it is inefficient to recover fixed costs through usage sensitive charges, yet reciprocal compensation rates are predominantly based on minute-of-use charges. Thus, current reciprocal compensation rate structures recover termination costs in a manner that does not reflect the way those costs are incurred.

- *Bill and keep fixes the problem by displacing existing minute-of-use rate structures in favor of a market-based approach. Under bill and keep, carriers will compete for the business of customers that terminate traffic and the market will drive rate and rate structures to efficient levels..*

3. Reciprocal Compensation is Premised on the Erroneous Assumption that the Calling Party, but not the Called Party, Benefits From and Should Pay the Full Costs of a Call.

Reciprocal compensation is based on the erroneous assumption that the calling party derives all benefits from a call and should be required to pay all costs of the call. The reality is, though, that both the called and calling party benefit and should share the costs.

- *Under a bill and keep regime, the costs of the call would be shared by the calling and called party.*

4. A Reciprocal Compensation Regime for ISP-Bound Traffic Can Result in Inefficient Over-Utilization of Telecommunications Facilities.

To the extent reciprocal compensation applies to ISP-bound traffic, ISPs theoretically need not pay for the telecommunications they use to connect to their end users. At the same time, ISPs have incentives to keep their customers on-line for as long as possible in order to maximize advertising revenues and revenues from Internet commerce. In fact, ISPs sometimes encourage their customers to stay on-line even when they are not actually using the Internet. This causes network congestion and requires inefficient investment in new facilities to ameliorate that congestion.

- *Under a bill and keep regime, ISPs would not have unfettered incentives to generate artificial on-line minutes.*